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DOL Issues Final Regulations Under ERISA Cross Trade Exemption

On October 7, 2008, the U.S. Department of Labor (“DOL”) published [final regulations](#), mandated by the Pension Protection Act of 2006 (“PPA”), to implement the new statutory exemption for cross trades of securities involving large ERISA-governed employee benefit plans. The final regulations largely adopt the provisions of the interim rule published in February 2007.

Background

The treatment of cross trades under ERISA has long been problematic. These transactions provide efficiencies that often can be beneficial to ERISA plans. Where an investment adviser or manager has discretion with respect to both of the client accounts involved in a cross trade, however, DOL’s view is that a cross trade gives rise to an ERISA §406(b)(2)-prohibited transaction — essentially, a conflict of interest — inasmuch as the adviser or manager is “representing” both sides of the transaction. Prior to the PPA, securities firms and DOL struggled to find a mutually acceptable solution for this concern:

- PTE 86-128, addressing certain conflicts of interest in securities transactions, permits a broker-dealer or other plan fiduciary to receive reasonable compensation from another party for effecting an agency cross transaction involving a plan, but only where the fiduciary provides advice and/or management to one side of the transaction.
- At least at one point, there was some practice of running cross trades through an unrelated broker-dealer in an effort to avoid a prohibited transaction. DOL’s position was that this approach was ineffective to eliminate the conflict, at least where the netting of the purchase and sale was prearranged. DOL actively pursued enforcement actions against several securities managers. It also granted limited individual exemptions to a small number of financial institutions.
- DOL ultimately granted a class exemption — PTE 2002-12 — limited to passive cross trades for index- and model-driven funds. The conditions of PTE 2002-12 are similar to those approved in the individual exemptions.
- DOL gave further consideration to but, to date, has declined to expand the scope of that relief to other circumstances where the manager has investment discretion for both sides of the transaction.

In the PPA, Congress attempted to bring some resolution to the regulation of cross trades by enacting new ERISA §408(b)(19), which generally allows an investment manager to effect cash purchases and sales of securities for which market quotations are readily available, between large plans and another account under management by the investment manager, subject to certain conditions. This exemption thus is somewhat more liberal in scope than DOL’s exemptions.

Under the PPA, DOL was instructed to consult with the SEC and issue regulations on certain conditions of §408(b)(19) — specifically, the content of required cross trade policies and procedures — within 180 days of enactment. DOL issued an [interim rule](#) on February 12, 2007, that took effect on April 13, 2007. The final regulation substantially follows the interim rule, with limited refinements. The preamble to the final regulation also addresses several other conditions of the exemption, outside the scope of the regulation, on which DOL received public commentary.

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Cross Trading Exemption as Explicated in the Final Regulations

As specified in the final regulation and explained in the preamble, the cross trade exemption provided by §408(b)(19) generally operates as follows:

- The exemption applies to cross trades between a plan (or a master trust for plans of related employers) with at least \$100 million in assets and any other account managed by the same investment manager.
 - “Investment manager” is defined by reference to the technical ERISA definition in §3(38). The same “investment manager” entity (including different portfolio managers employed by the same entity) must be managing both accounts; DOL declined to extend the scope of the exemption to cover cross trades between accounts managed by an investment manager and an affiliate of the manager, but offered that there would be no §406(b)(2) prohibited transaction in these circumstances unless there was an agreement or understanding to favor one managed account over the other in the cross trade.
 - DOL did not adopt commentary suggesting various modifications of the minimum asset requirement for plans investing in pooled investment vehicles, with the result that only pooled vehicles comprised solely of plans with at least \$100 million in assets can rely on §408(b)(19).
 - DOL did accept a suggestion that plan asset size be verified at initial participation in the cross trade program and annually (rather than quarterly) thereafter.
- The transaction must be a purchase or sale for no consideration other than a cash payment against prompt delivery of a security for which market quotations are readily available.
- The transaction must be priced at the independent “current market price” within the meaning of SEC Rule 17a-7(b) under the Investment Company Act of 1940, as amended (“1940 Act”).
- No brokerage, commission or fees (other than “customary transfer fees” disclosed in the written policies and procedures described below) may be charged for the transaction.
- The investment manager (i) must adopt written policies and procedures that are fair and equitable to all accounts, (ii) must include a description of policies and procedures for pricing and for allocating cross-trades among accounts in an objective and equitable manner, and (iii) must effect cross trades in accordance with those policies and procedures.
 - The policies and procedures must be sufficiently detailed to facilitate the periodic compliance review and determination described below, and must address, *inter alia*, (i) the criteria applied in determining that a cross trade is beneficial to both accounts; (ii) how the manager will determine “current market price,” including the identity of sources used to establish that price, in sufficient detail to permit the compliance review described below; (iii) procedures for ensuring compliance with the minimum asset size requirement; and (iv) the allocation method(s) available to and used by the manager to ensure an objective allocation among accounts participating in the program. (In the preamble to the interim regulation, DOL noted existing pro rata or queue systems and suggested there may be a number of objective allocation methods appropriate for this purpose.) A statement to the effect that the §408(b)(19) exemption includes several conditions in addition to the policies and procedures requirement must also be included.

- In the preamble, DOL declined to conform these disclosures to those required under Rule 17a-7, on either a definitive or a safe harbor basis. This position creates potential complexities for managers who execute cross trades for both ERISA plans and mutual funds.
- In a refinement from the interim rule, the final regulation requires the policies and procedures to contain a statement regarding the manager's conflicting loyalties (which DOL recharacterized as "inherent" rather than "potential") and responsibilities to the parties to a cross trade, and a description of how the manager will mitigate those conflicts.
- DOL declined suggestions to prescribe detailed specifications for the form and format of the disclosure, other than that it be clear, concise and calculated to be understandable by authorizing plan fiduciaries.
- The investment manager must, in advance, provide to a fiduciary (other than the manager or an affiliate) for each plan participating in cross trades a disclosure regarding the conditions on which the cross trades take place, including the written policies and procedures noted above.
 - Under the regulations, this disclosure must be in a document separate from any other document or disclosure involving the investment management relationship.
- That plan fiduciary must authorize, in advance and also in a separate document and after receipt of those disclosures, the investment manager to engage in cross trades at the manager's discretion.
- The plan fiduciary must receive quarterly reports detailing cross trading activities.
 - The report must contain detailed disclosures of all cross trades executed by the manager during the quarter, including the parties involved in each cross trade. DOL declined to relax the statutory requirements for this report.
- The investment manager cannot base its fee schedule or other services on a plan's consent to cross trading, but the investment manager can pass on to a consenting plan investment opportunities and cost savings available through cross trades.
- The investment manager must designate an individual (a compliance officer) (i) to periodically monitor compliance with its policies and procedures, and (ii) to issue an annual report (within 90 days of year end), under penalties of perjury, to the authorizing fiduciary describing the review, the level of compliance and any specific instances of non-compliance.

At least initially, many securities firms were highly skeptical about making use of §408(b)(19). There are significant practical challenges in validating, in the specified review, compliance with every condition of the exemption (particularly the pricing requirement, and particularly for fixed income investments) for every individual cross trade. These challenges, coupled with the requirement that the specified report be provided under penalties of perjury, make use of §408(b)(19) problematic even for a cross trading program that is in all respects designed and operated in overall compliance with the exemption. Accordingly, the utility of the exemption may depend significantly on the practicability of this requirement.

- The identity and qualifications of the compliance officer must be disclosed in the written policies and procedures. DOL judged, probably incorrectly in most circumstances, that such information could be material to a plan's decision to participate in the manager's cross trade program.

Accordingly, as the identity of the compliance officer changes, the manager's written policies and procedures will have to be revised. The regulation does not address if and when the disclosures required by the exemption must be amended and perhaps recirculated in the event of a material change, although the regulatory impact statement in the preambles to both the interim and final regulation suggest that might be required.

- The compliance officer may delegate his or her responsibilities to others but remains ultimately responsible for the compliance review under penalties of perjury.
- The compliance officer's review may be limited to compliance with the manager's written policies and procedures, rather than compliance with every condition of the exemption. The scope of the review is to be reflected in those policies and procedures, as well as in the report.
- In potentially helpful comments, DOL observed that nothing in the rule prohibits the compliance officer from basing his or her review on an appropriate sampling of cross trades, provided the sampling methodology is disclosed in the manager's policies and procedures.
- DOL rejected a commentator's suggestion that the compensation paid to the compliance officer not be materially affected by any cross trades.
- DOL also declined to equate this function with the role of the chief compliance officer under Rule 38a-1 of the 1940 Act.
- The annual report must include notification of the plan's right to terminate participation in the manager's cross trade program at any time. There is no explanation of how the termination right is intended to apply to plan invested in a pooled fund that makes use of §408(b)(19).

DOL stated that individual instances of compliance with the exemption, which are to be reflected in the compliance officer's report, would not alone render the exemption inapplicable to other cross trades that meet all the requirements of §408(b)(19).

The final regulation is effective as of February 4, 2009. A manager that obtained a fiduciary's authorization to a cross trading program prior to the effective date but based on compliance with the interim regulation is not required to obtain a re-authorization following disclosures that reflect the final regulation.



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